CAPITAL PROJECTS AND BOND OVERSIGHT COMMITTEE

Minutes

March 20, 2008

The Capital Projects and Bond Oversight Committee met on Thursday, March 20, 2008, at 9:00 AM, in Room 169 of the Capitol Annex. Senator Elizabeth Tori, Chair, called the meeting to order.

Present were:

Members: Senator Elizabeth Tori, Co-Chair; Representative Mike Denham, Co-Chair; Senator Jerry Rhoads; and Representatives Robert Damron, Steven Rudy, and Jim Wayne.

Guests testifying before the Committee: Larry Owsley, University of Louisville; John Hicks, Governor's Office for Policy and Management; Jim Abbott, Finance and Administration Cabinet; Michael Jones, Department of Military Affairs; John Nicholson, Kentucky Horse Park; Tom Howard and Terri Fugate, Office of Financial Management; Mark Offerman, Kentucky Housing Corporation; Bill Skees, Frost Brown Todd; and Jim Ackinson, Kentucky Higher Education Student Loan Corporation.

LRC Staff: Nancy Osborne, Shawn Bowen, Kristi Culpepper, Pat Ingram, Don Mullis, and Lesa Prewitt.

Senator Tori asked Nancy Osborne, Committee Staff Administrator, to review the correspondence and information items. Ms. Osborne said the first item of correspondence was from the Department of Commercialization and Innovation reporting three allocations exceeding $400,000 from the New Economy High-Tech Construction / Investment Pool for Smoothstone IP Communications Corporation (up to $500,000); 3DR Laboratories, LLC (up to $500,000); and dbaDIRECT, Inc. (up to $469,000).

The second item of correspondence was a report on the Administrative Office of the Courts' (AOC) Court Facilities Standards Committee meeting in March 2008. This Committee approved the Phase A schematic designs for four court projects for the counties of Campbell, Garrard, Marion, and Mercer and authorized each to proceed to the later phases of design.

At a previous Committee meeting, a question was raised as to whether Kentucky's court houses are adequately insured. Ms. Osborne said there is an ongoing discussion with AOC regarding the property insurance on court facilities.

The third item of correspondence was from the University of Kentucky reporting the purchase of three unbudgeted items of equipment.

Ms. Osborne then briefly reviewed various items in the monthly Staff Update. She said that due to current market conditions, the March Staff Update contained more in-depth information on the municipal bond market. Moody's has upgraded its rating of the Kentucky Public University Intercept Program from A1 to Aa3, which is the same rating as that of the State Property and Buildings Commission that issues General Fund appropriation supported debt. She also noted that some municipal bond insurers, such as Ambac, have been downgraded, placed on watch for a downgrade, or had their rating outlooks adversely revised. Ambac was the first AAA bond insurer to be impacted when it was downgraded to AA by Fitch in January. At a previous Committee meeting, it was reported that Ambac had been selected by the Louisville Arena Authority to insure the bonds for the Louisville Arena project.

Ms. Osborne noted that a Request for Proposals (RFP) was reissued for private development of facilities at Herrington Lake State Park on property to be acquired by the Commonwealth. She then briefly reviewed proposed legislation of interest to the Capital Projects and Bond Oversight Committee. Also included was the monthly and weekly debt issuance calendar, and a report of local issuer pool allocations for the 2008 Private Activity Bond Cap. She said that 80% of the private activity bond cap is allotted to state issuers, the Kentucky Housing Corporation and the Kentucky Higher Education Student Loan Corporation.

Ms. Osborne then introduced a new staff member for the LRC Capital Planning Advisory Board, Mr. Don Mullis. The Capital Planning staff and the Capital Projects staff work together and share a suite of offices.

Noting that a quorum was present, Chairman Tori asked the secretary to take the roll. Representative Rudy made a motion to approve the minutes of the February 19, 2008 meeting. The motion was seconded by Senator Rhoads and passed by voice vote.

Senator Tori next asked Larry Owsley, Vice President of Business Affairs, University of Louisville (UL), to discuss a request for a scope increase for the University of Louisville Expand Trager Field Hockey Stadium. This project was authorized in the 2006-08 budget at a scope of $3,200,000 (Other Funds). Mr. Owsley said the building site is very near the property line of campus, and the University received preliminary feedback that construction could not be any closer to the property line. The University has now received advice from consultants that a 1,600 SF addition can be added to the weight room and comply with concerns of the Fire Marshal relative to property line clearance. This expansion will allow for more simultaneous use of the facility and is a significant benefit for the university's gender equity program for intercollegiate athletics. He said UL has the money in hand.

Representative Rudy made a motion to approve the scope increase. The motion was seconded by Representative Wayne and passed by unanimous roll call vote. The revised project scope is $4,180,000.

Senator Tori asked John Hicks, Deputy State Budget Director, Governor's Office for Policy and Management, and Jim Abbott, Commissioner, Department for Facilities and Support Services, to present the monthly project report submitted by the Finance and Administration Cabinet.

Mr. Hicks reported an unbudgeted project for the Department of Military Affairs to construct Phase II of a Joint Support Counter Drug Operations Center in London, Kentucky. The project scope is $3,421,200 and is 100% federally funded. Mr. Hicks said the project will expand an existing facility already under construction. The Phase II project will include construction of a 14,559 SF facility, classroom space, library space, supply areas, maintenance bays, and a 2,000 square yard paved parking lot. The facility will house the Department of Military Affairs' Counter Drug Program that will be consolidated from locations in London, Frankfort, and Lexington (Bluegrass Station).

Mr. Hicks said Phase I of this project, at a scope of $1,922,300 (federal funds), was reported to the Committee in June 2007. It is expected to be completed September 2008.

In response to a question from Representative Rudy, Michael Jones, Executive Director, Office of Management and Administration, Department of Military Affairs, said this was a three phase project to be funded with federal funds earmarked each year. While there are no funds available yet for Phase III, he said the Department anticipates receiving federal funds from the next federal budget. If the Department does not receive Phase III funding, they will still have the flexibility to move operations from Bluegrass Station to London. The only thing not available would be the aviation hangar.

Representative Wayne asked what the Counter Drug Operations Program does. Mr. Jones said the program works with local and state law enforcement officials to stop drug trafficking in high intensity drug trafficking areas of the state. At this time, most of the program works out of London, but the administrative and supply operations are at Bluegrass Station.

In response to questions from Representative Wayne, Mr. Jones said program operations do not include clean-up of meth labs. He said the National Guard assists by providing helicopters, but mostly local law enforcement, state police, or other law enforcement agencies are responsible for remediating meth labs. He agreed with Representative Wayne's statement that the program is focused primarily on identification of drug trafficking areas, and arrests and seizure.

Representative Wayne said he had received mixed reports about how well meth labs are being cleaned up. In response, Mr. Jones said it was going well.

Representative Rudy made a motion to approve the project. The motion was seconded by Representative Wayne and passed by unanimous roll call vote.

Mr. Hicks next discussed a project to be developed by a private entity on state property at the Kentucky Horse Park (KHP). The project scope is $5,175,000 and is 100% privately funded through the United States Hunter Jumper Association, Inc. (USHJA). The state will execute a 99-year ground lease with the USHJA to construct a two-story 17,500 SF building to house the association along with a 70-car parking lot. The facility will be constructed on land adjacent to the existing restaurant at the Horse Park that is currently an employee parking lot. The association will pay prevailing wage in the construction of this project. At the end of the 99-year lease, the state will take ownership of the facility.

In response to questions from Representative Wayne, Mr. Nicholson said the staff to be housed in the new building are now in the United States Equestrian Federation building on campus. Mr. Nicholson added that the USHJA is establishing itself as an independent organization. The United States Equestrian Federation will occupy the space vacated by the USHJA.

Representative Wayne asked what capital renewal measures were in place to assure the facility will be commercially viable when the Commonwealth takes ownership after the 99-year lease is over. Mr. Hicks said the bulk, if not all of the ground leases executed by the state, have the provision that the Commonwealth shall assume ownership of the facility after a 99-year period. He said there currently is no budgetary mechanism for the Commonwealth to set aside funds for these privately developed facilities.

Mr. Abbott added there are safeguards within the USHJA lease agreement whereby the current owner or occupant of the building would have to maintain the facility respective to its appearance and maintenance in accordance with the desire and the needs of KHP. He said each of these lease agreements are worded to assure that the buildings are maintained appropriately, as it is the intention of the state to take ownership of a facility in good shape at the end of the lease.

Representative Wayne asked what the status of the lawsuit was related to the private development on state park property and the payment of prevailing wages. Mr. Abbott said there has been movement between the two parties to resolve the dispute that occurred relative to prevailing wage. He said the Franklin Circuit Court has yet to respond to the agreement that the two parties have proposed, but it is hoped that the court will dismiss the current lawsuit in the near future.

Representative Wayne asked for an update about the placement of bonds to finance the proposed private development of a hotel and conference center at the KHP. Tom Howard, Executive Director, Office of Financial Management (OFM), said it was his understanding that bonds have not been placed yet due to the turmoil in the market.

Representative Wayne asked when the bonds will be sold. Mr. Howard said it was hard to predict when this will happen, due to the current state of the financial market.

Senator Tori said no action was required by the Committee on the USHJA project.

Senator Tori next welcomed Sandy Williams, Financial Analyst, Kentucky Infrastructure Authority (KIA). Ms. Williams presented nine new KIA loans for the Committee's approval. She presented a Fund A (Federally Assisted Wastewater Revolving Loan Fund) loan for the Hardin County Water District #1 in the amount of $3,086,982 to finance acquisition of the City of Ratcliff's sewer system. The loan will have an 11-year term and a 3.80% interest rate. The fund A loan will be the sole source of financing for this project.

Ms. Williams next presented a Fund A loan for the Paducah McCracken Joint Sewer Agency in McCracken County for $1,600,000 to assist in funding a project to make water treatment plant improvements. The loan will have a 20-year term and a 1% interest rate. The Fund A loan will be combined with other funding for a total project scope of $4,146,560.

The next loan Ms. Williams presented was a Fund B loan (Infrastructure Revolving Loan Fund with state-supported debt service) for the Electric Plant Board of the City of Glasgow in Barren County. The City is requesting a Fund B loan in the amount of $1,100,000 to connect the broadband network of the City of Glasgow to the broadband network of the City of Bowling Green. The Fund B loan will be at .60% for 20 years.

Ms. Williams then reported a Fund B loan for the City of Lancaster in Garrard County in the amount of $490,000 to assist in funding a $844,200 project to make wastewater treatment plant improvements. The fund B loan will be at .60% for 20 years.

The last Fund B loan Ms. Williams presented was for the Whitley County Water District in Whitley County in the amount of $548,000 to assist in funding a $2,708,000 project to extend water lines and make water plant improvements. The Fund B loan will be a .60% for 20 years.

Ms. Williams then presented a Fund F loan (Federally Assisted Drinking Water Revolving Loan Fund) in the amount of $4,000,000 to the City of Hopkinsville for the

Hopkinsville Water Environment Authority in Christian County. The loan will be used to assist in funding a $11,300,000 project to expand water treatment plant capacity. The Fund F loan will have a 20-year term at a 1% interest rate.

The next Fund F loan presented was for the Northern Kentucky Water District in Kenton County for $4,000,000 to make water treatment plant improvements. The loan will have a 1% interest rate for 20 years. The loan will be combined with other project financing for a total project scope of $6,565,000.

Ms. Williams next reported a Fund F loan for the Ohio County Water District in Ohio County for $3,000,000 to assist in constructing a four million gallon per day water treatment plant. The loan will be at 1% for 20 years. These funds will be combined with other project financing for a total project scope of $21,802,350.

The last Fund F loan presented was for the City of Centertown in Ohio County in the amount of $2,770,810 to improve the City's water system. The loan will be for 30 years at an interest rate of 1% and be combined with other financing for a total project scope of $3,357,037.

Representative Wayne asked how the non-standard (hardship rates) were applied. Ms. Williams said KIA promulgated regulations providing four different ways to obtain the non-standard rate.

Representative Rudy made a motion to approve the nine KIA loans. The motion was seconded by Senator Rhoads and passed by unanimous roll call vote.

Ms. Williams next presented various coal/tobacco development grants that were funded through line item appropriations from the General Assembly in 2006. No Committee action was required.

The next report was provided by Mr. Howard and Terri Fugate, Deputy Executive Director, OFM. Ms. Fugate reported a new bond issue: the Kentucky Housing Corporation (KHC) Conduit Multifamily Housing Revenue Bonds, Series 2008, Partridge Pointe Apartments. The total cost of the project is $13,933,150, and includes $5,750,000 in KHC conduit financing.

Ms. Fugate said the proceeds from the bond issue will be used for the acquisition and renovation of a multifamily rental housing facility in Louisville. She said the interim financing will have a variable interest rate and will be converted to a permanent, fixed rate financing after two years.

Representative Wayne asked where Partridge Pointe Apartments are located. Mark Offerman, Chief Program Officer, KHC, said he was not familiar with the specific area but knew it was close to the Watterson Expressway and Taylor Boulevard.

Representative Wayne asked how many apartments there are and how many residents will need housing assistance. Bill Skees, Attorney, Frost Brown Todd, came to the table. He said there were 276 rehabilitated units, and the project is located just off Manslick Road and was once called Graystone. The Housing Partnership, Inc., is the prime developer. He said Graystone has been owned by the Partnership for a long time, and is being spun off into a limited liability company, which will use these bonds to rehabilitate all units at a cost of $11,000 per unit. The upgrades will include HVAC upgrades and washer and dryer hook-ups. There are an almost equal amount of one, two, and three bedroom units, and 40% of the units will be set aside for families of low to moderate income.

Representative Wayne complimented the people that put this project together, and said he was impressed and happy to hear about it.

In response to questions from Senator Tori, Mr. Skees said he did not know the square footage of the three bedroom unit, but he would be happy to get that information. He said the apartments are fairly old and the appraisal for the apartment complex was $11 million.

Representative Wayne made a motion to approve the KHC bond issue. The motion was seconded by Representative Rudy and passed by unanimous roll call vote.

Ms. Fugate next reported a new bond issue for Morehead State University (MoSU): MoSU General Receipts Bonds, 2008 Series A, for $4,423,401. Proceeds from this bond issue will be used to refund the university's outstanding 2000 Series N Housing and Dining System Revenue Bonds. Ms. Fugate said the proposed date of sale is May 1, 2008, but it is possible they will issue these refunding bonds earlier depending on the market. She said they anticipate a net interest rate of 3.5-3.6% depending on the market, and they will issue only if there are present value savings.

Ms. Fugate said the bonds are initially rated A1 by Moody's. But as stated earlier in the Staff Update briefing, the Kentucky Public University Intercept Program rating has been upgraded to from A1 to an Aa3, the same as the State Property and Buildings Commission General Fund lease appropriation debt. There is a stable outlook for this rating.

Senator Rhoads made a motion to approve the MoSU bond issue. The motion was seconded by Representative Rudy and passed by unanimous roll call vote.

Ms. Fugate reported that the Kentucky Asset/Liability Commission (ALCo) has issued Project Notes in two series of tranches to provide interim financing for projects authorized in HB 269 (2002-04 budget), HB 267 (2004-06 budget), and HB 380 (2006-08 budget). The series include ALCo Project Notes, 2005 General Fund Second Series Fourth Tranche, not to exceed $750 million; and ALCo Project Notes, 2007 Road Fund First Series A, Second Tranche, not to exceed $350 million.

Ms. Fugate said the same financing team has been used since 2005 and the Project Notes Program has been in place for two years to provide interim financing of authorized state projects. To date, about $170 million of the $200 million currently outstanding under the General Fund Project Notes Program has been spent. Ms. Fugate said OFM anticipated another State Property and Buildings Commission bond issue to provide permanent financing for General Fund projects. There remains a sizeable amount of authorized projects for which bonds have not been issued.

Relative to the Road Fund Project Notes Program, Ms. Fugate said a $50 million tranche was sold on March 5 and there is now $200 million outstanding under this program as well. This issue will finance the $350 million in road projects authorized in the 2006 session. This interim financing will ultimately be converted to permanent financing through bonds issued by the Kentucky Turnpike Authority.

Representative Denham asked how the current market conditions are affecting the state's investments. Mr. Howard said the tax exempt yield curve was steep, and they are financing expenditures under the commercial paper program.

Mr. Howard said the liquidity facility provided by Dexia Credit Local is relatively inexpensive, but it will expire sometime this fall. The state is paying seven basis points currently, and if this liquidity facility had to be replaced in today's market, it might cost as high as 40 basis points, if it was available at all.

Mr. Howard said some projects will be converted to permanent financing. In the longer end of the municipal yield curve, the 20 year unenhanced yield for State Property and Buildings Commission bond issues would probably be about 5.05% today and all-in costs would be approximately 4 1/2-4 3/4%. Municipal yields are currently higher than Treasury yields, which is unusual.

Next, Jim Ackinson, Chief Operating Officer, Kentucky Higher Education Student Loan Corporation (KHESLC), updated the Committee on the Corporation's progress in restructuring its outstanding debt. In January 2008, the Committee approved the issuance of up to $1.35 billion KHESLC Student Loan Revenue and Refunding Bonds (2004 Trust Restructuring). At that time, Mr. Ackinson informed the Committee that problems in the mortgage market had affected the market for auction rate securities, including the auction rate securities KHESLC has issued. Mr. Ackinson indicated that investors were moving away from this type of debt entirely, regardless of the issuer's credit.

KHESLC's loan business is capitalized by $2.2 billion in bonds, with all but $91 million in the form of auction rate securities. He said issuing auction rate debt worked well for about 15 years. Beginning in fall 2007, KHESLC started paying unprecedented high interest rates on its auction rate securities. Mr. Ackinson said the higher rates were necessary to attract new investors to auctions for the debt. As investor interest in the auctions decreased, the investment banks holding the auctions temporarily prevented the auctions from failing by purchasing and holding bonds themselves.

Mr. Ackinson said when KHESLC reported this bond issue in January, they intended to move out of auction rate securities and into variable rate demand notes. However, KHESLC has been working on this two months and because of market disruptions, has not been able to complete the transaction.

Mr. Ackinson said KHESLC could only find liquidity facilities in the form of standby bond purchase agreements from three banks for $500 million. He said liquidity is tight, banks are not as inclined to lend money or commit money as they have in the past, and those that do are charging relatively expensive fees. KHESLC was on the front wave of these transactions but has been held up, not only with negotiations with the liquidity facility providers, but also the tax analysis involved. He explained that there may be significant arbitrage liabilities that KHESLC does not want to have to rebate to the federal government. If a bond deal is treated as a reissuance, there is a tax liability. A tax counsel is working through these issues.

Mr. Ackinson said other issues have arisen since January. He said KHESLC also wants to refund its outstanding variable rate demand obligations (VRDOs) to remove the bond insurers. KHESLC is evaluating whether the Corporation can refund this debt and some of the auction rate debt through a general bond resolution from 1983. Of the debt that was originally issued under this general bond resolution, $91 million is currently outstanding. He said that since KHESLC can refund a limited amount of debt, the most expensive debt would be refunded first. The Corporation's tax-exempt debt presently has the highest interest cost.

Mr. Ackinson said all of KHESLC's auctions have failed. The interest rate KHESLC is paying on its auction rate debt is not a market rate, but a rate established in bond documents. Mr. Ackinson explained that KHESLC may be able to achieve most of its financing objectives under the scenario he described, but there is a policy shift involved that should be communicated to the Committee.

In 2003, KHESLC's enabling legislation was amended to the effect that the Commonwealth would no longer provide a moral obligation on any bonds issued by

KHESLC. He said the statutes were amended because the agency was contemplating providing not only federally reinsured student loans but also so-called "private alternative loans." During that time, KHESLC was also moving into risk-oriented out-of-state markets. Subsequently, KHESLC has not made any alternative loans and has retreated from out-of-state markets. To date, KHESLC has issued $1.2 billion of bonds under its 2004 general bond resolution.

Whatever bonds issued after 2004 that KHESLC decides to refund, it will have the effect of increasing the state's moral obligation on those bonds beyond what KHESLC has today. KHESLC needs the moral obligation pledge in order to successfully refund the bonds. Liquidity is tight and anything that differentiates KHESLC from other issuers of student loan bonds will be of great help.

Senator Tori asked when KHESLC plans to complete this transaction. Mr. Ackinson said they hope to complete the final tax analysis by the end of the week, determine what the final rating agency requirements will be, and complete the transaction within six weeks. He said this is effectively an economic refunding, and KHESLC is trying to get out of a higher priced instrument into a lower priced instrument.

Representative Denham noted that debt issued under the 1983 General Bond Resolution is backed by a moral obligation pledge of the state. He asked if there will need to be an appropriation in the current budget to allow this. Mr. Howard said there would be no action required during this budget cycle. He said if there was a draw on the available debt service reserve by the KHESLC and the Corporation could not replenish the reserve from its own resources through additional financing or equity, then the Governor and the Secretary of Finance would include in a future budget request the funds necessary to replenish KHESLC's reserve back to the amount stated in bond documents.

In response to a question from Representative Denham, Mr. Howard agreed that this restructuring is being done to reduce interest costs. He said not taking these actions has the impact of reducing KHESLC's earnings substantially. It is also a market access issue from both a rating perspective and with respect to locating a credit facility or standby bond purchase agreement.

Senator Tori thanked Mr. Ackinson and Mr. Howard for their work. She said they were moving very aggressively. No action was required by the Committee for this previously authorized issue.

Ms. Fugate presented 17 new school bond issues with School Facilities Construction Commission (SFCC) debt service participation: Augusta Independent (Bracken County), Bellevue Independent (Campbell County), Covington Independent (2) (Kenton County), Floyd County, Gallatin County, Harrison County, Henderson County, Kentucky Interlocal School Transportation Association, McCreary County, McLean

County, Menifee County, Owensboro Independent (Daviess County), Russellville Independent (Logan County), Union County, Walton-Verona Independent (Boone County), and Warren County.

Representative Wayne made a motion to approve the school bond issues. The motion was seconded by Representative Rudy and passed by unanimous roll call vote. Representative Damron abstained from the vote, citing a potential conflict of interest.

Next, Ms. Osborne reported five locally-funded school bond issues submitted to the Committee for review this month: Barren County, Franklin County, Kenton County, Madison County, and Meade County. She said all disclosure information has been filed, and no further action on the bond issues was required.

Senator Tori said the Committee's next meeting is tentatively scheduled for April 15, 2008, in the Capitol Annex Building. With there being no further business, a motion was made and seconded to adjourn the meeting. The meeting adjourned at 10:00 a.m.